Audit (Acct 4223) Case Study Requirements

Due Date

Paper is due April 27, 2016
Presentations will be on April 27 and 29, 2016 respectively.

Deliverables

1) Paper: 3 to 5 pages (Intro, Findings, Conclusion) – see format below
2) Power Point Presentation: 5 to 7 slides. Should be summarized information. Teams will be expected to present findings to the class in a summarized format. Teams will be expected to speak for 5 to 7 minutes.

Team Work:

Each team member will have an opportunity to evaluate other members of their team. Please be mindful that you will receive a team grade but each individual's grade can be adjusted accordingly.

Format:

Case 1: Baker Hughes – Foreign Corrupt Practices Act: The following questions should be answered in your paper:

1. What is the primary issue in the case?
2. Should the Board of Directors and / or external auditors be actively involved in policing foreign corrupt practices or is this a management issue?
3. Discuss the pros and cons of the two groups (independent investigators and blue – ribbon experts) used by Baker Hughes.
4. Evaluate whether the changes in Exhibit 4&5 are likely to stop foreign corrupt practices.
5. Discuss how compliance and governance changes are likely to impact the future profits and shareholder value at Baker Hughes.

Case 2: The SOX compliance journey at Trinity Industries.: The following questions should be answered in your paper:

1. What is the primary issue in the case?
2. Doug Collum described Trinity as a likely candidate for a material weakness in the first year of SOX compliance. What were the factors critical to Trinity's ultimate success in its first year?
3. In the design of their controls, Trinity moved from a practice-based, bottom up approach in year 1 to a risk management approach in year 2. Was this trajectory effective? How might they have proceeded effectively in year 1 in particular?
4. In 2008, how could Trinity further reduce SOX-related expenses? For each of your recommendations, be sure to take the barriers Trinity would face into account.
5. How well do you think Trinity 2008 governance, information technology, and process infrastructure will serve the organization with respect to new finance related legislation, such as IFRS

STANFORD
GRADUATE SCHOOL OF BUSINESS

ROCK CENTER FOR CORPORATE GOVERNANCE

CASE: CG-18
DATE: 08/01/10

BAKER HUGHES: FOREIGN CORRUPT PRACTICES ACT

When you have an issue in one country, you don't know that you have problems elsewhere, but you should assume that there is probably a similar problem someplace else. Therefore, you must design a system to prevent problems of the same nature from happening again and, if they do happen, ensure that you will find them. And not just in one country, but worldwide.[1]
—Alan Crain, Senior Vice President and General Counsel, Baker Hughes Incorporated

OVERVIEW

In 2002, a former employee of Baker Hughes filed suit against the company, alleging that he had been wrongfully terminated for refusing to participate in a bribery scheme in Nigeria. The allegations were troubling because, if true, they would not only be in violation of U.S. labor laws but could also constitute a violation of the U.S. Foreign Corrupt Practices Act (FCPA). The penalties for such violations are severe. Moreover, this would not be the first time Baker Hughes had been accused of bribing a foreign official. The first incident took place in 1999 and involved the authorization of a payment to a government official in Indonesia in an attempt to reduce Baker Hughes' tax liability in that country. Although Baker Hughes had stopped the bribe before it was ever made and had voluntarily disclosed the matter to U.S., the company was still operating under the resulting cease-and-desist order that subjected it to a higher level of scrutiny.

Baker Hughes reacted swiftly to the most recent allegations. In its first move, the company hired a third-party law firm to undertake an independent investigation of the events in Nigeria. The company also voluntarily reviewed its entire global operations, with the purpose of discovering

[1] Case writer interview, October 14, 2009.

Professor David F. Larcker and Brian Tayan prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The authors would like to thank Alan Crain, senior vice president and general counsel of Baker Hughes, for his extensive assistance in the preparation of these materials. The Rock Center for Corporate Governance is a joint initiative between the Stanford Graduate School of Business and the Stanford Law School.

other potential FCPA violations. All findings were shared with the Department of Justice and the Securities and Exchange Commission. Simultaneously, the company convened a blue-ribbon panel of experts to serve as advisors as the company engaged in a comprehensive restructuring of its policies and systems for preventing and detecting the issuance of questionable payments. Although these actions led to the discovery of additional violations, when completed, they allowed Baker Hughes to revamp business practices and compliance efforts so that they not only mitigated the risk of future infractions but fundamentally improved the way the company conducted business abroad.

Corruption in International Business

Corruption is defined as a situation in which an individual abuses a position of power for private gain. Although corruption can take many forms, it commonly manifests itself in a corporate setting when a government or ministry official demands payment as a precondition to awarding business or granting a service. Corruption occurs at both high and low levels of the government. For example, a corporation may be asked to pay a bribe by senior administrators during the approval process for a public project, capital equipment order, production sharing contract, or lease agreement.[2] A company may also be solicited to hire tax officials in their personal capacity, with the implication that the payments for their personal services will reduce a company's assessed tax liability in the country where they operate. Furthermore, routine services may be subject to corruption, such as shipment processing by customs, the acquisition of visas or permits, registration of intellectual property, and the upholding of basic protections by the judiciary. Bribery need not always involve the payment of cash, but may also include gifts, entertainment, discounts on products or services, personal favors such as the hiring of relatives, or the forgiveness of debts.

Multinational corporations that conduct business in developing and less-than-developed nations face a considerable risk that they will be exposed to corruption. According to the nonprofit organization Transparency International, almost 40 percent of executives in multinational corporations have been asked to pay a bribe when dealing with government and quasi-government offices. The risk is even more severe in poorer nations, such as Egypt, India, Indonesia, and Nigeria, in which more than 60 percent of respondents reported that they had been solicited for bribes.[3] According to one estimate, politicians and government officials worldwide receive bribes valued between \$20 billion and \$40 billion each year.[4]

While almost any business that interfaces with government or regulatory offices risks facing corruption, certain industries are more exposed. Industries involving major capital expenditures in which large dollar amounts trade hands—such as construction, airline manufacturing, power plants, and oil and gas production—are likely to encounter corruption as individuals attempt to use their positions of authority to siphon money for personal gain. In competitive contracting,

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[2] *Production sharing contracts* are contracts in which a company is awarded the right to extract natural resources such as minerals, metals, or oil, and gain on land owned by the government.

[3] Sample includes 2,742 executives in 26 developed and developing nations. Source: Transparency International, "Bribe Payers Index 2008." Available at: http://www.transparency.org/news_room/in_focus/2008/bpi_2008 (November 1, 2009)

[4] Transparency International, "Global Corruption Report 2009." Available at: http://www.transparency.org/publications/gcr/gcr_2009 (November 1, 2009).

companies that do not pay bribes face the risk that business will be awarded to a competitor. Industries that rely on a timely import and export activity risk having critical deliveries delayed.

Corruption exacts a severe economic toll on the nation in which it occurs. Corruption deters foreign investment by raising uncertainty about the timing, amount, and returns that a company can expect from an investment. In addition, corruption diverts resources from their most efficient use, increases the cost of business, and distorts public expenditure. According to estimates, corruption can increase the cost of a project by 10 percent.[5] Corruption also contributes to economic and political unrest by exacerbating income inequality, resulting in the denial of fundamental human rights for many citizens. (See **Exhibit 1** and **Exhibit 2** for statistics on international corruption.)

FOREIGN CORRUPT PRACTICES ACT (1977)

The Foreign Corrupt Practices Act (FCPA) was enacted in 1977 to reduce the incidence rate of corruption involving foreign officials and U.S corporations. Two events in particular preceded the FCPA and precipitated its enactment. The first was the Watergate scandal of the early 1970s, during which it was revealed that several U.S. corporations were engaged in the practice of making illegal contributions to domestic political campaigns. A follow-up investigation by the SEC revealed that such payments were widespread and involved not only U.S. officials but foreign ones as well. Moreover, payments were often misrepresented in companies' accounting systems in order to prevent detection by auditors.[6]

The second event involved the Lockheed Aircraft Corporation. In 1971, Lockheed received a $250 million loan guarantee from Congress to forestall a potential bankruptcy.[7] While the funds were primarily granted to improve the financial health of the company, the company used them in part to expand its international sales efforts. The SEC investigation into Watergate revealed that Lockheed had engaged in the repeated practice of bribing foreign officials to secure contracts. Total payments exceeded $22 million over multiple years. Lockheed defended its actions as important to winning international business and "consistent with practices engaged in by numerous other companies abroad."[8] Still, the scandal resulted in congressional hearings which broached the need for anti-bribery legislation.

In 1976, President Gerald Ford laid out the rationale for legislation to prevent businesses from paying bribes to foreign officials: "[The recent spate of scandals] has resulted in an erosion of confidence in the responsibility of many of our important business enterprises. In a more general

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[5] Ibid.

[6] The response to this investigation was led by the SEC's Director of the Division of Enforcement Stanley Sporkin. Sporkin conceived of a voluntary disclosure program, through which a company that conducted an internal investigation and turned over all records of bribery payments to the SEC would not be subject to enforcement actions. All voluntary disclosures were made available to the public. More than 500 companies participated, revealing over $300 million in bribes and questionable payments. See: Linda Chatman Thomsen, "Speech by SEC Staff: Remarks before the Minority Corporate Counsel 2008 CLE Expo," March 27, 2008. Available at: http://www.sec.gov/news/speech/2008/spch032708lct.htm (November 1, 2009).

[7] Lockheed was the second largest defense contractor at the time, and its financial health was seen as important to supporting the war effort in Vietnam.

[8] "Scandals: Lockheed's Defiance: A Right to Bribe?," *Time*, August 18, 1975.

way, these disclosures tend to destroy confidence in our free enterprise institutions."[9] U.S. Secretary of Commerce Elliot Richardson elaborated: "Bribery corrodes the confidence that must exist between buyer and seller if domestic and international commerce is to flourish. It threatens to poison relationships between the United States and nations with which we have long had mutually beneficial political and commercial ties."[10]

Ultimately, Congress enacted the Foreign Corrupt Practices Act (FCPA) of 1977 to address the issue. The FCPA included two main provisions: an anti-bribery provision and a books and records provision. The *anti-bribery provision* made it illegal for a U.S. corporation to offer payments to a foreign official for the purpose of "obtaining or retaining business" or "securing any improper advantage."[11] The *books and records provision* made it illegal for companies to fail to "keep books, records, and accounts" that reasonably reflect the nature of transactions. This provision was intended to deter companies from burying illegal payments in generic accounts such as "travel and entertainment," "consulting fees," or "commissions." It was also a violation of the books and records provision for a company to fail to develop reasonable accounting controls for detecting FCPA infractions.

The FCPA included several important exceptions that limited its scope. First, the act applied only to U.S. companies whose shares were registered with the SEC and traded on a public exchange. Foreign corporations listed in the U.S. were not covered by the act. Second, the law applied only to company employees that offered or agreed to pay bribes (the *supply* side).[12] It did not apply to the foreign officials who solicited or accepted bribes (the *demand* side). Finally, the act created an exemption for facilitating payments. *Facilitating payments* were defined as payments whose purpose was "to expedite or to secure the performance of a routine governmental action." This included obtaining permits, processing visas, or actions of a similar nature.[13] Although a materiality threshold was not specified, facilitating payments were generally assumed to be payments of less than a few hundred dollars.

INTERNATIONAL HARMONIZATION OF ANTI-CORRUPTION LAWS (1998)

Business leaders complained almost immediately that the terms of the FCPA put U.S. corporations at a competitive disadvantage relative to international firms that did not operate under similar restrictions. At the time, no other nation had laws similar to the FCPA. U.S. corporations involved in heavy manufacturing and large-dollar capital expenditures were seen as

[9] Message from the President of the United States Urging Enactment of Proposed Legislation to Require the Disclosure of Payments to Foreign Officials (August 3, 1976).

[10] Hearings before the Senate Committee on Banking, Housing, and Urban Affairs (April 7-8, 1976). Statement of Elliot L. Richardson, Commerce Secretary.

[11] Prohibited payments were defined as any "furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value." Source: The U.S. Department of Justice, "The Foreign Corrupt Practices Act, Anti-Bribery and Books and Records Provisions." Available at: http://www.usdoj.gov/criminal/fraud/docs/statute.html (November 1, 2009).

[12] This included any "officer, director, employee, or agent" of the company.

[13] A full list of exemptions stipulated in the act included obtaining permits or licenses; processing visas and work orders; providing police protection, mail pick-up and delivery, or scheduling inspections associated with the transit of goods across country; providing phone service, power and water supply; loading and unloading cargo; protecting perishable products from deterioration; and actions of a similar nature.

most at risk of losing business. For example, in 1979, the National Constructors Association estimated that U.S. corporations had fallen to fifth place in the market for international construction, behind Japan, Korea, West Germany, and Italy. Three years earlier, the U.S. had ranked number one in that industry. One member of the construction trade group, Chicago Bridge & Iron Company, estimated that it had lost "in excess of $100 million of sales over the last three years [...] where we think the element of bribery was at least present."[14]

A 1981 report by the General Accounting Office (GAO) reached a similar conclusion. According to the GAO, over 30 percent of companies had lost a bid in recent years to a competitor that paid a bribe. The report was based on a survey of the 1,000 largest corporations in the U.S. Aircraft manufacturers and construction companies were among the corporations that were most likely to report lost business.[15]

In 1995, Commerce Secretary Ron Brown told Congress that, during the previous year, U.S. businesses lost contracts valued at $45 billion to foreign companies that paid a bribe. The information was based on a report compiled using the resources of the Central Intelligence Agency. The report—which focused primarily on the business tactics of French, English, German, Japanese, and Canadian companies doing business abroad—uncovered "almost 100 cases of foreign firms using bribery to undercut U.S. firms' efforts to win international contracts." It went on to say that "foreign firms that offer bribes typically win about 80 percent of the deals."[16] The commerce secretary told reporters that U.S. companies were essentially competing "with one arm tied behind their back."[17]

Corporations put pressure on public officials to level the playing field by urging the country's major trading partners to adopt anti-bribery legislation similar to the FCPA. Other nations, however, were resistant. As late as 1997, the United States remained the only country in the OECD with a specific statute criminalizing bribery. In approximately half of OECD nations, bribery was explicitly allowed. In ten OECD nations—including Australia, Canada, Germany, Greece, and Luxembourg—such payments were tax-deductible.[18]

By the late 1990s, however, international sentiment about corruption began to shift. Two factors in particular contributed to this trend. First, many nations were caught in high-profile scandals involving the bribery of public officials. Politicians in Ireland, Italy, South Korea, and Japan all resigned following revelations that they had accepted illegal payments from major corporations. Second, a growing body of academic literature clearly demonstrated the link between political corruption and reduced economic growth. In response, international organizations began to take

[14] "Anti-Bribery Law Said to Cut U.S. Firms out of Markets," *The Wall Street Journal*, August 2, 1979.

[15] Robert Pear, "G.A.O. Urges Easing of Corrupt Practices Act," *The New York Times*, March 5, 1981.

[16] David E. Sanger and Tom Weiner, "The CIA in Transition," *Austin American Statesman*, October 22, 1995.

[17] Jim Zarroli (interview), "Commerce Secretary Reveals Unethical Foreign Practices," *National Public Radio (NPR)*, October 13, 1995.

[18] In 1997, there were 29 nations in the Organization for Economic Cooperation and Development (OECD): Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, South Korea, Sweden, Switzerland, Turkey, United Kingdom, and United States. For international acceptability of bribes, see: "Is Corruption an Asian Value?" *The Wall Street Journal*, May 6, 1996; and Paul Lewis, "Straining Toward an Agreement on Global Bribery Curb," *The New York Times*, May 20, 1997.

proactive steps to put pressure on developing nations to crack down on corruption. The World Bank introduced spot audits, whereby governments found to have participated in large-scale corruption would be blacklisted from receiving future loans. The International Monetary Fund also made tackling corruption a top policy objective.

In response to changing international sentiment, the OECD agreed to participate in the fight against corruption. In 1997, OECD member nations signed an accord committing to enact anti-bribery legislation that was similar to the FCPA in their own countries by the end of the following year. This agreement came to be known as the OECD Convention and was seen as a major step toward reaching a global ban on commercial bribery.[19]

The U.S. Congress amended the FCPA in 1998 to conform to the OECD Convention and expand the reach of the statute. The amendments made it illegal for any U.S. person or entity to do any act outside of the U.S. in furtherance of conduct prohibited by the FCPA. In addition, foreign subsidiaries of U.S. corporations could be held liable under the FCPA if any of their foreign officers, directors, employees, agents or stockholders engage in prohibited conduct in the U.S. Moreover, non-U.S. companies who issue securities, including American Depository Receipts ("ADR"), in the U.S. remain subject to the FCPA.

Despite international harmonization of anti-bribery legislation, corruption continued to be a problem in many countries. According to a 2009 study conducted by Transparency International, the incidence rate of bribery remained high, particularly in the Middle East, Africa, and newly independent countries such as Russia and the Ukraine. Respondents reported that they were most likely to be solicited for a bribe by the police, the judiciary, permit offices, and tax authorities.[20]

PROSECUTION OF THE FCPA

The Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) enforced the FCPA on behalf of the U.S. government, and brought criminal and civil penalties against companies found in violation. The DOJ and SEC often coordinated their investigations, but they acted independently and sought their own penalties. The Department of Justice brought criminal charges against a company, negotiated a settlement, and recommended penalties that were then approved by a court. The fines levied as punishment were dictated by federal guidelines but could be reduced based on whether it was a first-time or repeat offense, the level of cooperation exhibited by the company during the investigation, and the steps taken to address the problem and prevent future infractions.

The SEC had its own enforcement authority and sought its own penalties. Typically, these included both fines and disgorgement of profit. The amount of disgorgement was calculated based on the total estimated profit earned as a result of the bribe. In the case of a major capital project, this figure could be substantial. As part of the settlement, the SEC typically imposed a

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[19] Still, the OECD Convention did not apply to many important emerging economies, such as China and Russia.

[20] Transparency International, "Global Corruption Barometer 2009," available at: http://www.transparency.org/policy_research/surveys_indices/gcb (November 1, 2009).

cease-and-desist order, which prohibited the company from repeating the offense. Future violations by a company that operated under a cease-and-desist order carried higher penalties.

Both the number and size of enforcement actions against companies for violating the FCPA increased in recent years. In 2002, the DOJ and the SEC each settled five cases, for a total of $3.2 million in fines and penalties. In 2008, the number of settlements was 19 and 13 by those agencies, respectively, and carried a total of $890 million in fines and penalties (see **Exhibit 3**).[21] According to the DOJ, there were 120 open cases in 2009 against companies for potential FCPA violations.[22] One former prosecutor stated, "There has been a dramatic increase in the resources dedicated to enforcing the law by the Justice Department … and even more important, a strong public commitment to compliance as well as enforcement."[23]

Two factors in particular contributed to increased enforcement of the FCPA. The first was the USA Patriot Act of 2001, which expanded the powers of federal law enforcement agencies to search communications and records for the purpose of combating terrorism. This facilitated the investigation of international money laundering and drew links to the bribery of foreign officials. The second was the Sarbanes-Oxley Act of 2002, which raised the accountability standards of directors and senior executives and led to stricter oversight by regulators. Following Sarbanes-Oxley, companies had to increase their compliance efforts to protect themselves against financial and reputational risk.

COMPLIANCE WITH THE FCPA

Corporations implemented enhanced internal controls and risk management policies to prevent and detect illegal payments. Because FCPA violations carried both criminal and civil penalties, compliance with the act became a board-level issue. Typically, the audit committee of the board of directors assumed this responsibility. The general counsel's office also played a significant role along with the internal audit function. Companies disseminated education and training materials to employees, informing them of their affirmative obligations under the FCPA. This included education about both the anti-bribery and the books and records provisions of the act. Employees were instructed to immediately report all potential violations to their supervisor and to the legal department. The external auditor also selectively monitored for potential FCPA violations by spot-checking transactions or accounts that were likely to contain questionable payments, but this was not a primary objective of the audit process.

While devising control mechanisms was a relatively straightforward exercise, ensuring effectiveness was more difficult. A 2008 survey by PricewaterhouseCoopers found that while 80 percent of senior executives said their companies had FCPA compliance policies in place, only 22 percent were confident that these were effective.[24] Similarly, a 2009 study by Transparency

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21 PricewaterhouseCoopers, "Corruption Crackdown," 2009. Available at: http://www.pwc.com/us/en/ foreign-corrupt-practices-act/publications/index.jhtml (November 1, 2009).

22 Cited in: Dionne Searcey, "U.S. Cracks Down on Corporate Bribes," *The Wall Street Journal*, May 26, 2009.

23 Nelson D. Schwartz and Lowell Bergman, "Payload: Taking Aim at Corporate Bribery," *The New York Times*, November 25, 2007.

24 PricewaterhouseCoopers, "Corruption Crackdown," 2009, loc. cit.

International found that 90 percent of large multinational corporations had anti-bribery codes but fewer than half monitored compliance.[25]

For many corporations, compliance with the grey areas of anti-bribery legislation was a particular challenge. One such grey area involved small-dollar payments. Because the FCPA did not specify a materiality threshold for bribes, even nominal expenditures that involved a government official (such as a token gift or entertainment expense) could potentially be construed as a violation. Facilitating payments were another grey area. It was not always clear whether a payment was made to expedite a routine government service or was a bribe. It depended on the nature of the request and the office of the government employee. Furthermore, while facilitating payments were legal under the FCPA, they were often illegal under the laws of the local country. Company employees that made facilitating payments were exposed to potential criminal prosecution under local law, even though such laws were only rarely enforced. The employment of third-party agents was a third dangerous grey area. Multinational corporations hired agents with special knowledge of the local economy to represent them in conducting business. Because of their professional networks and specialized knowledge, these individuals could be particularly effective in winning business contracts and navigating regulatory bureaucracy. However, there was also risk that they would engage in questionable behavior to accomplish their objectives. According to one lawyer, "Many American companies get in trouble because they don't do due diligence and check out the foreign agents they use."[26]

BAKER HUGHES AND THE FCPA

Baker Hughes was formed through the merger of Hughes Tools and Baker International in 1987. Hughes Tools and Baker International were both worldwide leaders in drilling technology, and the merger created one of the major players in this market.[27] The company also had deep expertise in many activities that improved the efficiency of oil extraction, including well logging services, directional drilling, drilling fluids and systems, and flow control equipment. By 2000, Baker Hughes had operations in over 65 countries, with revenues of $5.2 billion, profits of $102 million, and a market capitalization of $13 billion. In developed countries, several companies normally competed on bids for a major project. In developing countries, where conditions were more difficult, often only two or three companies would have the necessary expertise and technology to bid.

As an oilfield service company, Baker Hughes did not directly engage in exploration and production but instead was a contractor to companies that performed these activities. These included both publicly traded corporations such as ExxonMobil and Royal Dutch Shell and state-controlled entities such as Saudi Aramco. While the responsibilities of providing services to a public company and state-owned company were the same, the contracting process was different.

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[25] Transparency International, "Global Corruption Report 2009," loc. cit.

[26] Paul Burnham Finney, "Shaking Hands, Greasing Palms," *The New York Times*, May 17, 2005.

[27] Hughes Tools was founded in 1909 by Howard Hughes Sr., father of the famous inventor and businessman Howard Hughes. Hughes Sr. founded the company to commercialize his invention of rotary drill bit technology, used to drill oil wells through rock. Howard Hughes Jr. assumed control of the company following his father's death in 1924 and was responsible for the company's success over several decades. The invention of rotary drill bit technology was so important that variations on the basic design continued to be in use a century later and remained an important product of Baker Hughes.

A publicly traded production company negotiated a production sharing contract with the national government, which gave them the right to look for oil and gas and manage its production. Once the agreement was in place, the production company then contracted with a service company such as Baker Hughes that owned the equipment needed for extraction. State-owned companies did not need to enter into production sharing contracts and contracted directly with the oilfield service company to deliver equipment. In this case, a company such as Baker Hughes had to compete to win business that was awarded by a government-owned entity. Once an oilfield service agreement was in place, equipment had to be imported. It was important that the service company be able to deliver equipment on schedule, as delays were extremely costly to the project.

Allegations in Indonesia (1998)

On September 12, 2001, Baker Hughes settled allegations with the Securities and Exchange Commission that company employees had authorized a cash payment to an Indonesian tax official, in violation of the FCPA. Baker Hughes neither admitted nor denied the allegations but agreed to cease and desist from future violations of the FCPA.[28]

The settlement stemmed from an incident that began in 1998 when the Indonesian ministry of finance informed a subsidiary of Baker Hughes that it was auditing a recent tax filing in which the company claimed a substantial tax refund. Following a preliminary review, Baker Hughes was informed that it would not receive a tax refund but would instead be assessed a liability of $3.2 million. Baker Hughes asked its tax accountant KPMG to review the determination. KPMG concluded that the findings were in error. During a meeting with an Indonesian tax official to discuss the matter, KPMG was asked to have Baker Hughes pay a $200,000 "goodwill payment" in return for which the official would reduce the assessed tax liability. A regional tax manager for Baker Hughes instructed KPMG not to make the payment but to continue to challenge the tax liability based on its merit.

In a follow-up meeting, the Indonesian tax official offered to reduce the tax liability from $3.2 million to $270,000 in exchange for a lesser payment of $75,000. KPMG informed the regional tax manager for Baker Hughes that it would be willing to make the payment on behalf of the company and pass the charge through to Baker Hughes by adding it to an invoice for tax services. KPMG would disguise the payment under the single line item "professional services rendered." The regional tax manager for Baker Hughes discussed the matter with the company's controller and an FCPA advisor. The FCPA advisor informed them that the payment would be in violation of the FCPA. The regional tax manager continued to discuss the matter with the controller and argued that the payment would give Baker Hughes "certainty" over its taxes. The controller informed both the CFO and the general counsel of Baker Hughes of the matter. The general counsel concluded that the payment would be in violation of the FCPA. The controller and CFO, however, disregarded his advice and authorized the payment through KPMG. KPMG generated the invoice and Baker Hughes entered the transaction on its books as professional

[28] Information in this section from: Securities and Exchange Commission, Accounting and Auditing Enforcement Release No. 1444, in the Matter of Baker Hughes Incorporated, September 12, 2001. Available at: http://www.sec.gov/litigation/admin/ 34-44784.htm (November 1, 2009). In addition to the matters discussed here, the enforcement action also cited violations involving lesser payments in India (1998) and Brazil (1995). Baker Hughes neither admitted nor denied these allegations.

services rendered. Shortly thereafter, the Indonesian tax official determined that Baker Hughes' tax liability was $270,000.

The general counsel discovered the authorization of payment and intervened. Baker Hughes attempted to stop payment on the invoice to KPMG. It also disclosed the matter to the Securities and Exchange Commission and the Department of Justice. The employees involved—including the CFO and controller—were terminated, and KPMG was dismissed as tax accountant. In addition, Baker Hughes paid the Indonesian ministry of finance $2.1 million, which it estimated to be the appropriate tax assessment.

Following settlement with the SEC, Baker Hughes began the process of strengthening its internal controls. The company hired a chief compliance officer. It also developed new training programs and more detailed policies on protecting against FCPA violations. In addition, the company established a toll-free call number through which employees could ask questions and make anonymous disclosures about potential FCPA compliance issues.

Allegations in Nigeria (2002)

In March 2002, a former employee of Baker Hughes filed suit against the company, alleging that he had been wrongfully terminated after refusing to pay a bribe to an agent in Nigeria. The employee had previously been division manager of BHI Inteq, a drilling subsidiary of Baker Hughes. In 1999, BHI Inteq bid on a two-year, $70 million contract to provide drilling services for the Shell Nigeria EA Shallow Offshore project. The project was managed by Royal Dutch Shell and jointly owned by Shell, the Nigerian National Petroleum Corp, Total, and Eni.

The employee alleged that he and a colleague had been approached by an agent who claimed to have an inside contact at Shell Nigeria. The agent was said to offer to help BHI Inteq secure the contract if the company would share a percentage of the revenue with his firm. The division manager of BHI Inteq claimed that he balked at the offer and notified the human resources department of the matter. Shortly thereafter, he was transferred to a project in the United States and terminated five months later. He alleged that his termination was due to the fact that he had refused to participate in the bribery scheme. BHI Inteq ultimately hired the agent in question and won the contract in 2001.

The allegations were troubling, not only for their legal implication, but because they occurred just six months after the settlement with the SEC regarding the situation in Indonesia. As such, Baker Hughes was still operating under a cease-and-desist order

As a first step, Baker Hughes convened a panel of independent investigators to look into the matter. The investigators were from a Washington, D.C.-based law firm which had no affiliation with Baker Hughes and did not provide other legal work for the company. As such, they were expected to report objectively to the board and without conflict of interest because they did not rely on the company for other revenue. The move was considered a best practice in internal investigations. The team was led by a former prosecutor for the Department of Justice who was familiar with the steps required to satisfy investigators from that agency. The role of the lawyers was to focus on the events in Nigeria and determine what had occurred. The investigators reported their findings to the audit & ethics committee of the board. The board, in turn, authorized the general counsel and the investigators to relay all information that was uncovered to the DOJ and the SEC.

At the same time, the company convened an independent panel comprising blue-ribbon experts to review the investigative actions and advise the company as it sought to move forward. The recommendation to convene a second panel was made by Alan Crain, general counsel of Baker Hughes.[29] It was Crain's belief that the board would benefit from independent advice on how to improve compliance efforts. To this end, Crain recruited individuals of high integrity and significant experience to serve on the panel: Judge Stanley Sporkin, former head of enforcement at the SEC; James Doty, former general counsel for the SEC; and Alan Levenson, former head of corporate finance for the SEC.

The advisory panel met with Crain, the investigative lawyers and the audit & ethics committee of the Baker Hughes board throughout the review. They reviewed the progress of the investigation and offered counsel. They also reviewed the steps taken by the company to improve internal controls and devise new systems and processes to better comply with the FCPA. In this way, they served as quality control. Their work gave assurance to the board that the company was not only taking appropriate action to resolve its immediate legal situation but also was making improvements that would last going forward. The policies that came out of this effort were ones that both reduced risk and improved the fundamental way the company conducted business with clients around the world.

Findings of the Internal Investigation

The investigative panel found no evidence of illegal activity in Nigeria. It was determined that Baker Hughes did not improperly terminate the employee who filed the grievance. Also, no evidence was found that Baker Hughes violated or attempted to violate the FCPA by making improper payments, either to the agent in question or to Shell. While the agent did have a brother who worked at Shell, there was no evidence that the agent used this relation in an improper manner.

Still, many troublesome findings came out of the investigation. Even though there was no evidence of illegal activity, the agent's behavior was nevertheless suspicious. Large dollar amounts flowed through his agency with insufficient documentation to explain their purpose. Also, there was not a clear business case for why this particular agent was hired. The use of an agent could be warranted in instances where he had proven technical expertise, previous experience as the head of the product line that he was representing, or if he had previously worked for the appropriate local ministry. In such cases, agents had credibility representing Baker Hughes' services and there might be a clear business case for using their services. The agent in question, however, did not have any of this experience, and it was not clear why employees at Baker Hughes had employed him. The company responded to these findings by promptly terminating their relationship with him.

Although the matter might have been closed at that point, it was not. The general counsel, the advisory panel and the board recognized that if the use of an agent was questionable in Nigeria, it

[29] Crain became general counsel at Baker Hughes in October 2000.

was likely that similar problems existed in other parts of the company. In addition, as a result of other investigations that it had been conducting, the DOJ directed that Baker Hughes provide information regarding its operations in Angola and Kazakhstan. As a result of these considerations, Baker Hughes decided to expand the scope of its internal investigation and proactively examine all agents for the company. To this end, the general counsel asked to see the file on every single agent employed by Baker Hughes. He wanted to know if there was a clear business case for why each agent was hired. Because there was no central repository of agent related information, the general counsel initiated a program to identify every agent and found that there were several hundred. Working cooperatively with the business operations vice presidents, he moved quickly to terminate more than one half of all the agents within a short period. Baker Hughes also voluntarily turned over all findings in this examination to the DOJ.

Several things came out of this internal investigation. First, Baker Hughes determined that its existing policy on the hiring of agents had not been properly enforced. The policy called for a central list of agents, but none existed. The policy also called for division heads to keep background information on all agents in a repository that could be examined by internal auditors. This too had not happened. Second, the company discovered that there was insufficient justification for many of the agents that it employed. Because agents were paid a commission for their services, it was important that division heads be able to justify each one on a cost-benefit basis. The general counsel and advisory panel discovered that in many cases, this calculation had not been done. As such, it was not clear that there was always an economic basis for the agents the company employed. Third, Baker Hughes identified risks involving other types of agents such as processing agents, which were relied on to facilitate routine services such as visa acquisition, calculation of import taxes, and expediting shipments through customs. The activity of these agents had also not been closely monitored.

Finally, the investigation uncovered several violations of the FCPA in a wide range of countries including but not limited to Nigeria, Angola, Indonesia, Russia, Uzbekistan, and Kazakhstan. Many of these were minor incidences and did not involve a direct attempt by employees to pay or cover up bribes. In all cases these violations involved insufficient effort in monitoring agent behavior including:

- From 1998 to 2004, Baker Hughes authorized commission payments of nearly $5.3 million to an agent who worked in Kazakhstan, Russia, and Uzbekistan without adequately determining whether the payments were in part to be funneled to government officials.

- Between 2000 and 2003, Baker Hughes paid certain freight forwarders to import equipment into Indonesia using a "door-to-door" process without adequately determining whether the payments were being passed on to Indonesian customs officials.

- Between 2001 and 2005, Baker Hughes authorized payments to certain customs brokers to facilitate the resolution of alleged customs deficiencies without adequately determining whether the payments were being passed on to Nigerian customs officials.

- From 1998 to 2003, Baker Hughes paid an agent more than $10.3 million in commissions without adequately determining whether the payments were being passed on to employees of Sonangol, Angola's state-owned oil company, to obtain or retain business in Angola.[30]

That is, while Baker Hughes did not directly or indirectly participate in any attempt to bribe foreign officials, the company had failed to verify that its money was not being used for this purpose. Importantly, it was Baker Hughes that discovered each of these violations through the course of its expanded internal investigation and brought them to the attention of the DOJ and SEC.

The case of Kazakhstan was more severe. Baker Hughes' investigation discovered that on two occasions, the company hired agents in that country with express knowledge that the agents had indicated that some or all of the payments made to them were intended to bribe government officials. The first instance occurred in 1998. Baker Hughes hired an agent to help win a contract with KazTransOil, a state-owned oil transportation company. Baker Hughes paid the agent $1 million, despite learning that the agent's representative was a senior executive of KazTransOil. Then, in 2000, Baker Hughes hired an agent even though the company had express knowledge that the agent had stated that he intended to pay bribes to government officials in order to win a contract with Kazakhoil, Kazakhstan's state-owned oil company. The agent was paid $4.1 million, despite providing no identifiable services for that fee. Baker Hughes won the contract, which generated $219 million in revenues over a six-year period.[31]

Actions Taken

The findings of the internal investigation were seriously disappointing, embarrassing and costly for the company. However, the board of directors—with the support of the CEO, the general counsel and the advisory panel—used the opportunity to make fundamental changes to the company's business practices with an eye toward improving compliance and creating sounder operating procedures going forward. Alan Crain, general counsel of Baker Hughes, explained: "We decided to change the entire business approach, and then put in very tight controls and parameters, which included audits of the whole system."[32]

The most important changes were made to the process by which the company hired agents. The internal investigation indicated that the use of agents posed substantial legal risk. It also highlighted questions about the economic value of these individuals. Payments made to agents were substantial, often exceeding $1 million, and yet the internal investigation suggested that division managers had insufficient knowledge of the services rendered in return. The company decided that before a division head could hire any agent, it had to submit a thorough business justification to support the request. In other words, operations personnel would have to provide a detailed financial and operational analysis as to why use of the agent was the optimal business

[30] Details of these incidences quoted directly from: Securities and Exchange Commission, Accounting and Auditing Enforcement Release No. 2602, "SEC Charges Baker Hughes with Foreign Bribery and with Violating 2001 Commission Cease-and-Desist Order," April 26, 2007. Available at: http://www.sec.gov/litigation/litreleases/2007/lr20094.htm (November 1, 2009).
[31] Ibid.
[32] Quotations from Alan Crain in this section derive from the case writer's interview, October 14, 2009.

approach. The company would also have to perform extensive due diligence on the agent to ensure FCPA compliance.

The business justification required that the division head explain the services expected of the agent and why the use of an agent was preferable to potential alternatives. Alternatives included utilizing existing or new employees to fill the role, recruiting employees from other divisions to fill the role, and leveraging an agent used by another division.

Furthermore, the division manager was required to perform extensive due diligence on the agent to verify his integrity and willingness to comply with anti-bribery legislation. The due diligence process included a questionnaire completed by the agent; a verification of the answers provided on the questionnaire; interviews with references to assess the agent's reputation, competence, and integrity; and an assurance that the prospective agent understood both the anti-bribery and books-and-records requirements of the FCPA (see **Exhibit 4** for information about the due diligence process). Division managers were also required to identify and address red flags uncovered through the due diligence process. These included any ties with foreign officials, either direct or through family members or business interests; requests for unusual payment terms; requests for secrecy; or a history of inaccurately describing services on invoices (see **Exhibit 5** for red flags).

The business justification and due diligence file were to be submitted to the senior vice president of the division and to the chief compliance officer for approval. In addition, the business justification would have to be reviewed and approved (if necessary after additional information was developed and provided) by an outside independent senior attorney. Following approval, a signed agreement was executed between the company and the agent. The division manager was required to monitor the performance of the agent over the life of the contract. Payments over $20,000 required a review by the compliance officer. Furthermore, each agent was required to undergo a recertification process no less than every two years and was subject to comprehensive legal and financial audits at any time. During the recertification process, the division manager verified the accuracy of the information in the agent's file and identified and addressed new red flags. Moreover, if an agent failed to fully cooperate with an audit, the agent was terminated.

The new procedures not only improved FCPA compliance at Baker Hughes but improved the company's business operations. Within a few years the company reduced the number of agents to less than 10 percent of agents it had identified in 2002. Because of its comprehensive process the company lost business that it might otherwise have obtained. In some cases, agents that the company fired were signed by competitors and the business that Baker Hughes previously had went to its competitors. In other cases, Baker Hughes' compliance processes took so long to complete that it was unable to respond to business opportunities in the allowable time. Still, on the whole, the change brought many benefits. Division managers knew much more information about the agents they hired because of the due diligence process. In addition, when agents were not employed, division employees developed closer relations working directly with customers. This allowed them to improve customer service and also to grow relations more profitably than they had previously.[33] According to Crain,

[33] For example, when Baker Hughes eliminated sales agents in countries of the former Soviet Union, the company lost business for a period of time. However, within two years after training new local employees Baker Hughes

> By focusing on getting rid of agents, it forces the line business guys to really get to know their clients and develop relationships with their clients. They get to know them better, they get to know what they need more clearly, and they are able to service them better. So in many areas, by developing these direct client relationships, we have more business than we would have had if we had the agent.

In addition to restructuring the hiring process for agents, Baker Hughes also made changes to its policy on facilitating payments. In consultation with the general counsel and the advisory panel, the board of directors disallowed the use of all facilitating payments throughout the company.[34] Although facilitating payments were expressly allowed under the FCPA, they were in most cases illegal in the countries where Baker Hughes did business. Crain explained that the new policy was intended for the protection of company employees:

> It may be legal under U.S. law to pay the customs official, but it is probably illegal and a crime under the local law for you to make that payment and for the customs official to receive it. Often the law is ignored, but our business codes of conduct require that we obey the laws applicable in all the countries where we do business. ... Even though local officials may not currently be enforcing these laws, if we allow facilitating payments it can expose our people to the potential to be criminally prosecuted.

Furthermore, the company believed there were ethical issues in allowing employees to make facilitating payments. While not categorized as bribes by the FCPA, facilitating payments nevertheless fell into a moral grey area. From one perspective, they could be viewed as a payment for improved service, similar to a gratuity payment in a U.S. restaurant. In that regard, they were a form of wage supplement, often for employees that were paid inadequate wages. From another perspective, facilitating payments represented an abuse of power by individuals in a position to extract economic rents. These payments, on a macro scale, tended to distort economic growth and deter foreign investment. Furthermore, government offices that allowed facilitating payments also tended to be corrupt at higher levels.

Settlement with Federal Agencies

In April 2007, Baker Hughes reached a settlement with the SEC regarding the violations uncovered during the internal investigation. The company agreed to pay a civil penalty of $10 million for violation of the 2001 cease-and-desist order. The company also agreed to disgorge

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successfully increased revenues to record levels in those countries while improving operating profit (in part as a result of eliminating agent commissions) and enhancing compliance. By May 2009, Baker Hughes had launched a new global business structure moving from a product line focus to a geographic focus. This new structure provided direct accountability for compliance while also allowing Baker Hughes a single point of customer contact, thus improving cross selling of products and services in country. During the same time frame, Baker Hughes was given new work by two separate National Oil Companies ("NOCs") because there had been allegations of compliance improprieties in the country and the NOCs said they knew of BH's reputation for strict compliance standards and needed to ensure there would be no future improprieties.

[34] An exception was made in circumstances that involve "an imminent threat to the health, safety or welfare of any employee or member of his or her family or a co-worker." This exception was to be applied narrowly and the facilitating payments policy was strictly enforced including the immediate reporting of any such payment.

$23 million in profit. The figure of $23 million was calculated to include all profit earned on the Kazakhstan oilfield project between 2001 and 2006, plus interest.[35]

At the same time, a subsidiary of Baker Hughes pled guilty to criminal charges for violating both the anti-bribery and the books-and-records provisions of the FCPA. The company agreed to pay a fine of $11 million. It also entered into a two year deferred prosecution agreement with the DOJ and agreed to retain a monitor for three years who would assess the implementation and effectiveness of the company's new internal policies.

While the size of the penalties appeared large, they were significantly below federal sentencing guidelines. The DOJ recommended a reduced settlement because of Baker Hughes' cooperation and disclosure during the investigation, which the judge praised in his decision:

> First, and most important, [Baker Hughes'] cooperation with the government has been exemplary. The willingness of [it] to devote such substantial resources to its investigation, and the extensive voluntary disclosures of evidence uncovered by that investigation, shed light on the characteristics of the defendant and on the need for the sentence imposed to promote respect for the law. [Baker Hughes'] commitment to the ideal of responsible corporate citizenship, manifested throughout the investigation by its diligence and candor, is a significant mitigating characteristic and demonstrates that respect for the law is already ingrained in [Baker Hughes'] corporate values and culture.[36]

[35] The settlement, in terms of money paid, was only for violations in Kazakhstan. Other countries were cited in the settlement agreement but no fines or penalties were assessed under the settlement.

[36] The full case and settlement terms with the Department of Justice are reproduced in: Baker Hughes, form 10-Q for the quarter ending March 31, 2007, Exhibit 99.3, Sentencing Memorandum and Motion for Waiver, filed with the Securities and Exchange Commission, April 30, 2007.

Study Questions:

1. Discuss the economic and social impact of bribes and other similar payments in emerging economies.

2. Is the "optimal" amount of bribery payments for a company equal to zero?

3. Should the board of directors be actively involved in policing foreign corrupt practices or is this a management issue?

4. Discuss the pros and cons of the two groups (independent investigators and blue-ribbon experts) used by Baker Hughes.

5. Discuss whether the payments outlined on pages 12 and 13 are foreign corrupt practices.

6. Evaluate whether the changes in **Exhibits 4** and **5** are likely to stop future foreign corrupt practices at Baker Hughes.

7. Discuss how the compliance and governance changes are likely to impact the future profits and shareholder value at Baker Hughes.

Exhibit 1
Perception of Corruption in Selected Countries (2008)

Corruption Perception Index (2008)

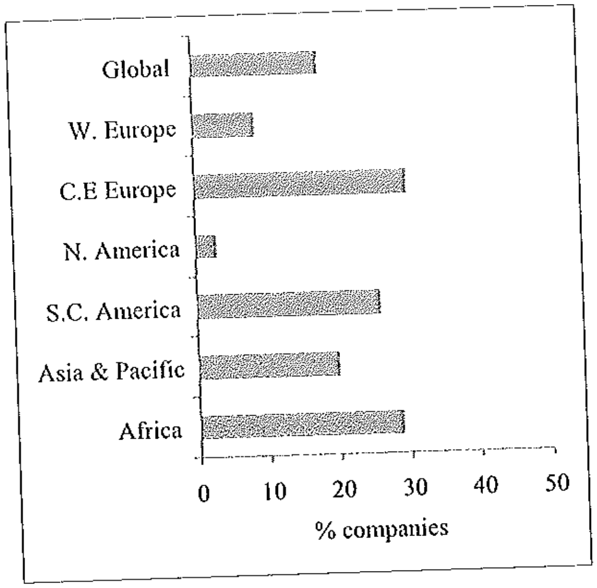
Country Rank	Country	2008 CPI Score
1	Denmark	9.3
5	Switzerland	9.0
12	Hong Kong	8.1
14	Germany	7.9
16	United Kingdom	7.7
18	Japan	7.3
18	United States	7.3
23	France	6.9
28	Spain	6.5
35	United Arab Emirates	5.9
47	Malaysia	5.1
55	Italy	4.8
72	China	3.6
72	Mexico	3.6
80	Brazil	3.5
85	India	3.4
96	Lesotho	3.1
109	Argentina	2.9
115	Egypt	2.8
121	Nigeria	2.7
128	Indonesia	2.6
134	Ukraine	2.5
141	Iran	2.3
145	Kazakhstan	2.2
147	Russia	2.1
158	Angola	1.9
166	Uzbekistan	1.8
173	Sudan	1.6
180	Somalia	1.0

Notes: CPI Score indicates the perception of the degree of corruption as seen by business executives and country analysts. Scores range from 10 (low perception of bribery) to 0 (high perception of bribery). 180 countries are included in the sample.

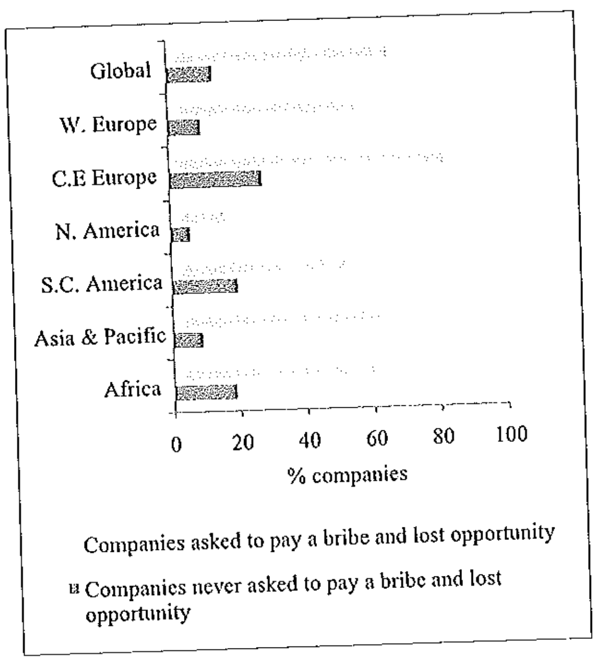
Source: Transparency International. Available at: http://transparency.org/policy_research/surveys_indices/cpi/2008 (November 1, 2009).

Exhibit 2
Incidence Rates of Bribery by Geographic Region (2008)

Percentage of Companies Asked to Pay a Bribe



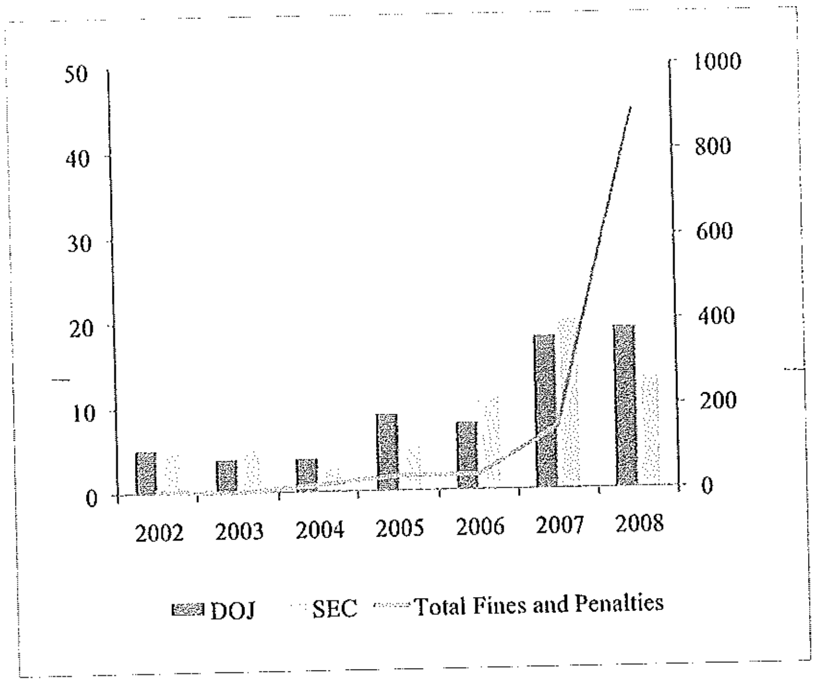
Companies Asked to Pay a Bribe That Lost an Opportunity to a Competitor



Source: PricewaterhouseCoopers, "Corruption Crackdown," 2009.

Exhibit 3
FCPA Proceedings (2008 – 2008)

<u>FCPA Proceedings, Fines and Penalties Brought Against Companies and Individuals (2002 – 2008)</u>



Source: PricewaterhouseCoopers, "Corruption Crackdown," 2009.

Exhibit 4
Baker Hughes: Due Diligence Requirements for Doing Business with Agents

The following is a summary of the steps that must be followed to comply with the FCPA Due Diligence Procedures:

- ☐ The contract should include, among other things, the following provisions:
  - The representative's obligations to strictly comply with the FCPA;
  - The representative's obligations to maintain separate books and records; and
  - The company's right to audit the representative's books and records, including documents pertaining to the representative's interaction with the government on behalf of Baker Hughes.
- ☐ All representatives must be listed in the Legal Due Diligence Database.
- ☐ Compile, document and preserve the information collected during the selection process of the representative. At a minimum, this information should include:
  - Experience and skills of the representative;
  - Business reputation of the representative, especially with other U.S. companies; and
  - Representative's and family's relationship to any political parties, candidates, foreign officials or entities.
- ☐ Assure that any relationship between the representative or the representative's family and a political party or foreign official is permissible under local law.
- ☐ Document the rationale for the rate of commission.
- ☐ Include an explanation of the services that will be provided and the basis for believing the compensation is reasonable.
- ☐ Conduct an in-person interview with the candidate, preferably at the representative's place of business, and explain the company's expectations and anti-bribery policies. There must never be any body language or implicit understanding to suggest anything less than full compliance with anti-bribery policies and laws.
- ☐ Verify the information the representative provides on background questionnaires and other forms submitted to the company.
- ☐ Require yearly certificates of compliance from the representative stating an understanding of the applicable anti-bribery laws and compliance with both the company's policies and applicable laws.
- ☐ Maintain and update the representative's due diligence file with any new information gained during periodic reviews of the relationship.
- ☐ Conduct a recertification process for the representative at least every two years.

Source: Baker Hughes Guide to Complying with the Foreign Corrupt Practices Act.

Exhibit 5
Baker Hughes: Red Flags When Doing Business with Agents

When dealing with representatives and joint venture partners, Baker Hughes employees have a continuing duty to be alert for suspicious circumstances, the so-called "red flags." Several examples of common red flags are provided below:

- ☐ The country where the transaction is taking place has a history of corruption.
- ☐ The representative was specifically recommended by a foreign official.
- ☐ The representative refuses to agree to abide by the FCPA.
- ☐ The representative provides incomplete or inaccurate information in required disclosures.
- ☐ The representative requires that payment be made to a third party or in some other country.
- ☐ The representative requests an unusually large commission in relation to the service provided.
- ☐ The representative requests reimbursement for poorly documented (or questionable) expenses.
- ☐ The representative makes unusually large or frequent political contributions.
- ☐ The representative has family or business ties to relevant foreign officials.
- ☐ The only qualification the representative has is influence over foreign officials.

The list above is not exhaustive and employees must be alert for any circumstances that raise questions concerning payments made to third party representatives. In particular, employees should never be afraid to scrutinize and question commission payments to representatives.

Source: Baker Hughes Guide to Complying with the Foreign Corrupt Practices Act.